United States Court of Appeals

for the Second Circuit

APPELLANT'S SUPPLEMENTAL BRIEF

ORIGINAL

75-7203

United States Court of Appeals

For the Second Circuit

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P/S

ROBERT ABRAHAMSON and MARJORIE ABRAHAMSON,
Plaintiffs-Appellants,

v.

MALCOLM K. FLESCHNER, WILLIAM J. BECKER, HAROLD B. EHRLICH, FLESCHNER BECKER ASSOCIATES, and HARRY GOODKIN & COMPANY,
Defendants-Appellees.

ON APPEAL FROM AN ORDER OF THE UNITED STATES DISTRICT COURT FOR THE SOUTHERN DISTRICT OF NEW YORK

SUPPLEMENTAL BRIEF FOR APPELLANTS ON THE QUESTION WHETHER THE GENERAL PARTNERS OF DEFENDANT FLESCHNER BECKER ASSOCIATES WERE INVESTMENT ADVISERS WITHIN THE MEANING OF THE INVESTMENT ADVISERS ACT OF 1940

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MALCOLM K. FLESCHNER, WILLIAM J. BECKER, HAROLD B. EHRLICH, LEON POMERANCE, FLESCHNER BECKER ASSOCIATES, and HARRY GOODKIN & COMPANY,

Defendants-Appellees.

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Docket No. 75-7203

SUPPLEMENTAL BRIEF FOR APPELLANTS ON THE QUESTION WHETHER THE GENERAL PARTNERS OF DEFENDANT FLESCHNER BECKER ASSOCIATES WERE INVESTMENT ADVISERS WITHIN THE MEANING OF THE INVESTMENT ADVISERS ACT OF 1940

Statement

Following oral argument of this appeal, and in an interim opinion dated November 21, 1975, this Court requested supplemental briefs on the issues raised herein under the Investment Advisers Act of 1940 (hereinafter "the Advisers Act"). The supplemental briefs requested were filed by all parties and by the Securities and Exchange Commission ("SEC") as *amicus curiae*. Thereafter,

and on February 25, 1977, the Court issued its decision reversing the judgment below, which had dismissed the complaint, and remanding the case for trial.

Defendants-Appellees, supported by several new amici curiae, then petitioned for a rehearing as to all issues decided. By order dated April 15, 1977, this Court granted the petition for rehearing to the limited extent of requesting that the parties and amici furnish the Court with a more thorough briefing on the issue of whether the general partners of defendant Fleschner Becker Associates (hereinafter "FBA") were investment advisers within the meaning of the Advisers Act.

As is discussed more fully below, on the facts of this case, the general partners squarely fit the definition of "investment adviser" set forth in the Advisers Act, and their regulation under that act is entirely in accord with the Congressional purposes. Defendants do not seriously attack the proposition that the general partners fit the statutory definition. Instead, they argue that, despite the language of the statute, they were not intended to be regulated under the Advisers Act. Defendants make no claim, and cannot, that their activities were subject to regulation under the Investment Company Act of 1940 (hereinafter, "Company Act" or "Investment Company Act"). Thus, in effect, the

general partners argue that, so long as the frauds they commit upon the limited partners do not directly involve the purchase or sale of a security by the limited partners, the activities of the general partners may not be regulated at all under any of the federal securities laws.

Defendants urge that the Congress did not intend to regulate private "investment partnerships" under the Advisers Act, that this Court misapprehended the "nature" of FBA and that the SEC has never attempted to regulate private investment partnerships under the Advisers Act. We show below that all three contentions are simply wrong.

In addition, one of the _amici_ has pointed out that the term "investment adviser" is defined in the _Company Act_ in a way which would exclude officers, directors, trustees, advisory board members or employees of an investment company. See _amicus_ brief of Steinhardt, Berkowitz & Co. (hereinafter, "Steinhardt Brief"), pp. 5-8. From this, the _amicus_ argues that the definition of "investment adviser" in the Advisers Act ought be read the same way, even though it contains no similar exclusion in the definition of "investment adviser." We urge below that this contention is also incorrect, and that actually the argument cuts the other way. The fact that the Congress thought it necessary specifically to ex-

clude internal managers from the definition of "investment adviser" in the Company Act reinforces the conclusion that general partners of investment partnerships are covered by the Advisers Act, which contains no similar exclusion.

POINT I

THE GENERAL PARTNERS HERE SQUARELY FIT THE DEFINITION OF "INVESTMENT ADVISER" CONTAINED IN THE ADVISERS ACT, AND INCLUSION OF THEM IN THE DEFINITION WOULD FURTHER THE PURPOSES OF THE ACT

The term "investment adviser" is defined in Section 202(a)(11) of the Advisers Act, 15 U.S.C. § 80b-2(a)(11), as follows:

> "'Investment adviser' means any person who, for compensation, engages in the business of advising others, either directly or through publications or writings, as to the value of securities or as to the advisability of investing in, purchasing or selling securities, or who, for compensation and as part of a regular business, issues or promulgates analyses or reports concerning securities ...."

It is plain that there are several elements to the definition. A person is an investment adviser if he:

1) engages in the business of advising others concerning securities; or

2) as part of a regular business, issues or promulgates analyses or reports concerning securities; and

3) does either of these things for compensation.

There can be no doubt that the activities of the general partners in this case constitute engaging in business. This Court has already observed that FBA carried out its activities on a regular basis and over a period of years. See slip opinion, pp. 6215-16. There can be no claim that the activities of the general partners in this case, so far as they relate to securities, took place on only a few isolated occasions. Defendants themselves concede that FBA was an "investment partnership." See petition for rehearing on behalf of defendants Fleschner, Becker, FBA and Ehrlich, p. 1, _et seq_. (hereinafter, "Defendants' Petition").

Moreover, the partnership agreements of July 1, 1965 and April 1, 1966 contain many references to the fact that it was a "business" which the partnership would engage in. See, e.g., Article First of the July 1, 1975 agreement, at p. 2 (40a*) ("principal place of business"); Article Third of the April 1, 1966 agreement, at p. 4 (69a) (general partners required to devote best efforts to "the Partnership business").

* References followed by "a" are to pages of the Joint Appendix on this appeal.

Nor is there any question that the general partners of FBA engaged in their activities "for compensation." The partnership agreements involved were before the Court as part of the record, and the Court has found as a fact that

> "Each of the three partnership agreements in effect between 1965 and 1970 provided that the general partners would be paid for their services 20% of the firm's net profits and net capital gains for each fiscal year. In addition, the partnership agreement of October 1, 1968 authorized an annual salary of $25,000 for each general partner who managed investments." Slip opinion, pp. 6222-23.

As we understand it, the defendants take no issue with the finding that the general partners did what they did "for compensation."

Finally, we believe it is clear that the general partners of FBA were in the business of "advising others" with respect to securities, and that it was "part of" their "regular business" to "issue or promulgate analyses or reports concerning securities."

First, we think it is abundantly clear that managing the securities investments of others constitutes "advising others" with respect to securities. The majority opinion of this Court makes this demonstration by pointing to passages

in both the legislative history and in the Advisers Act itself which make the conclusion inescapable. The Court has noted, for example, that the SEC study which led to the adoption of the Advisers Act referred not only to investment advisers who made recommendations to clients, but also to investment advisers "with management powers over their clients' funds and the power to make purchases and sales for their clients ..." (slip opinion, p. 6224). The Court has also noted (slip opinion, pp. 6224-25) that the Report of the Senate Committee on Banking and Currency which accompanied the bill to the Senate floor stated,

> "The report of the Commission to the Congress and the record before the committee is clear that the solution of the problems and abuses of investment advisory services--individuals and companies which either handle pools of liquid funds of the public or give advice with respect to security transactions--cannot be effected without Federal legislation."
>
> * * *
>
> "Virtually no limitations or restrictions exist with respect to the honesty and integrity of persons who may solicit funds to be controlled, managed, and supervised." (Emphasis added.) S. Rep. No. 1775, 76th Cong., 3d Sess., 21 (1940).

There are, of course, other portions of the legislative history, and there are provisions in the Advisers

Act itself, which lead to the same conclusion and which the Court has cited. We need not refer to them further.

As we read the petitions for rehearing, and the various briefs of the amici who support the petitions, no contention is made to the effect that managing or controlling funds or securities of others is not included within the meaning of "investment advice."

The general partners of FBA also issued monthly reports to the limited partners. This Court has held that these reports also provided investment advice (slip opinion, p. 6223). The defendants argue that the sending of "one sentence monthly reports setting forth the percentage increase or decrease in the value of the partnership's holdings cannot constitute the giving of investment advice" (Defendants' Petition, p. 3). Defendants also point out that the monthly reports did not mention particular securities or investments (ibid.).

We know of no authority for the proposition that advice is not investment advice unless it relates to particular securities and unless it is of a certain length.

In making this argument, the defendants overlook the facts of this case. They understate to a considerable

extent the comprehensiveness of their own reports. See, for example, the report for the period April 1 through July 31, 1966, which was attached as an exhibit to the affidavit of defendant Becker in the Court below (109a):

> "Since April 1st, we have lost 2.4% on the long side, and gained 5.3% on the short side for a net gain of 2.9%. During this period, the Standard & Poors 500 Stock Average declined 6.3%. Although we are not satisfied, we feel this has been a satisfactory performance in a most difficult and frustrating market. We are encouraged by our ability to preserve capital in the most severe market decline since 19 2.
>
> "During the past month, we increased our risk in the expectation of a market rally. In the absence of such rally, we have again reduced our risk to 40%, hoping to protect our capital against further market deterioration, while maintaining well selected long positions that would participate in a rising market.
>
> "We will no longer distribute a list of our positions, but will be happy to discuss our securities with you on the telephone."

Not only does this report contain a rather elaborate explanation of the general partners' trading strategy, but it also confirms that there was a time when an actual physical list of securities was distributed to the limited partners. The affidavit of defendant Becker confirms that

such a list was distributed for a time (34a). Plaintiff Marjorie Abrahamson testified on deposition that defendant Fleschner told her that the general partners discontinued the practice of distributing a list of securities to avoid the possibility that outsiders, persons who were not partners of FBA, might obtain copies of the lists and attempt to take advantage of them by making similar purchases (Marjorie Abrahamson dep., pp. 121-22).

Nor can it be overlooked that, according to the above quoted report, the general partners expressly stated that they would be "happy to discuss our securities with you on the telephone," even though lists would no longer be distributed. This statement seems to us to be a very clear recognition that investment advice, including advice as to specific securities, was involved in the relationship.

In the latter part of 1967, the monthly reports became shorter, but they continued to contain an advisory dimension, in addition to a report on performance during the previous month. For example, the report as of November 2, 1967 stated, "We continue to maintain a low risk stance" (198a); the report for December 1, 1967 stated, "We remain in a most conservative posture" (199a); the report for February 2, 1968 stated, "We have maintained the previously mentioned low risk stance through the cur-

rent market weakness" (200a); and the report for April 2, 1968 stated, "Our investment posture remains most conservative" (201a).

These communications, while certainly concise, functioned as advice in a nutshell, as well as retrospective reports. They disclosed how the general partners were dealing with the "current market" (emphasis added), both in the preceding weeks and, presumably, in the immediately forthcoming weeks.

These brief but important communications conveyed "investment advice" because they contained what the limited partners must have understood were summaries of the general partners' market philosophy and the tactics they were pursuing in the face of then current market conditions. Such crystallizations of the thinking of the general partners must be held to have been "advisory" communications, since they contained intelligence upon which the limited partners could act, or could choose not to act. This Court has pointed out, in the majority opinion in this case, that proper disclosure may have enabled the plaintiffs, not only to withdraw their funds, but also to try "to persuade the general partners to conform the firm's investments" to a different investment policy (slip opinion, p. 6237). The Court has also pointed out that "plaintiffs might have mobilized the other limited partners to exert pressure on the general partners" (*ibid*.).

Where "advisory" services by an investment adviser are involved (i.e., recommendations, see slip opinion, p. 6224), the client may react by accepting or rejecting the recommendations made. It seems logical to us that where "discretionary" investment services by an investment adviser are involved (purchases and sales by advisers with management powers over their clients' funds, slip opinion, p. 6224), the only courses open to the investor are to withdraw from the relationship, to protest the decisions being made, or to accept those decisions and say nothing. Thus, because they are reports on which investors may act, reports as to "discretionary" services are no less the giving of investment advice than recommendations made in the course of "advisory" services.

To illustrate the dynamics of the relationship, we may hypothesize what the investors might have done if the general partners had more accurately portrayed their market strategy, during the year of the reports quoted above, in the following manner:

> "We are confronting the current market weakness by building up substantially our portfolio of restricted stock which poses substantial liquidity problems and severely inhibits a rapid response to a falling market."

We suspect the Abrahamsons might have been joined in pro-

test by other investors who had theretofore been satisfied with the "low risk stance" (200a) purportedly maintained by FBA.

In any event, the monthly reports would certainly seem to have been "analyses or reports concerning securities" which the general partners issued "as part of a regular business," within the meaning of Section 202(a)(11) of the Advisers Act. The reports certainly were reports "concerning" securities, and they were "analyses" in the sense that they analyzed the performance of the investments of FBA in comparison to certain public indices. Nor is there any doubt that they were issued as part of the regular business of the general partners.

The annual reports sent to limited partners after the close of each fiscal year might also be deemed to have been either the giving of investment advice, or analyses or reports concerning securities. The annual reports were mandated by the partnership agreements (see, e.g., 76a, 103a). Although the annual reports in this case were disseminated by the outside accountants for FBA, it was shown by deposition testimony that the general partners examined the annual reports, in draft and final form, before they were mailed, and that the general partners consulted with the accountants over the format of the reports before they were mailed (144a -146a).

Finally, the deposition testimony showed that defendant Fleschner, at least, was a general partner who gave plaintiffs investment advice on a very personal level. He solicited plaintiffs' initial investment in FBA (then called The Fleschner Co.), having earlier persuaded them to invest in another investment partnership called A.W. Jones* (Fleschner dep., pp. 50-59, 172a-181a). More importantly, he gave plaintiffs investment advice after plaintiffs became limited partners in FBA, advising them from time to time, for example, to sell certain securities and contribute the proceeds to their capital accounts in FBA (see, e.g., Marjorie Abrahamson dep., pp. 28-29, 40-46).

The term "investment adviser" was "defined broadly" in the Advisers Act. See SEC Institutional Investor Study Report, Volume 2 (1971), p. 144. The SEC is empowered, should the breadth of the definition work an injustice in a particular case or class of cases, to designate by rules and regulations or by order that certain persons not within the intent of the statutory definition be excluded from the definition. 15 U.S.C. § 80b-2(a)(11)(F).

* This same partnership, or one of its successors, would appear to be one of the <u>amici</u> supporting the petition for rehearing in this case.

There is no injustice in including general partners of investment partnerships in the definition of "investment adviser," and so far as we know the SEC has never made any rule, regulation or order generally excluding general partners of investment partnerships from that definition.*

The general partners of FBA fit quite easily and quite clearly within the definition of "investment adviser." Contrary to the suggestion of one of the <u>amici</u> (Steinhardt Brief, p. 10), it requires no "stretching" to hold that the definition covers the general partners.

* * *

The defendants and <u>amici</u> argue that the general partners of investment partnerships, and the general partners of FBA in particular, have certain characteristics which show that they should not be included within the definition of "investment adviser" despite the fact that they seem quite literally to be included within the meaning of the words of that definition. We deal with the par-

* The defendants and <u>amici</u> cite a few instances where the SEC has exempted a specific person or organization, asserting that those cases are like this case. In fact, as we show below in the section of this brief which deals with the history of the SEC's attitude toward general partners of investment partnerships, the few cases cited by defendants rest upon very particular facts which are not here present.

ticular assertions made on this subject in a later section of this brief.

First, however, we wish to point out that a holding that the general partners of investment partnerships are included in the definition of "investment adviser" would do no violence to the purposes of the Advisers Act, and would in fact further those broad purposes.

We have previously pointed out in our initial supplemental brief that the essential purpose of the Advisers Act was to protect investors from the malpractice of investment advisers. See our initial supplemental brief, pages 11-16, and legislative history therein cited. And this Court has observed that the purpose of the Advisers Act was not only to protect "persons relying on their investment advisers for advice" (slip opinion, p. 6230), but also to control the activities of "persons who receive compensation for investing funds of their clients" (slip opinion, p. 6225).

Finally, as this Court has pointed out (slip opinion, pp. 6224-25), the Congress specifically intended that the Advisers Act cover "individuals and companies which ... <u>handle pools of liquid funds</u> of the public ..." S. Rep. No. 1775, 76th Cong., 3d Sess., 21 (1940) (emphasis added).

As the Supreme Court said in <u>SEC</u> v. <u>Capital Gains Research Bureau</u>, 375 U.S. 180, 195 (1963),

> "Congress intended the Investment Advisers Act of 1940 to be construed like other securities legislation 'enacted for the purpose of avoiding frauds,' not technically and restrictively, but flexibly to effectuate its remedial purposes."

Here, the general partners of FBA were persons who handled the liquid funds of the limited partners, were persons upon whom the limited partners relied for advice in the form of investment decisions and reports, and were persons who were paid compensation for their services. They were the sort of persons which the Advisers Act was specifically designed to control, and the limited partners who relied upon them were the sort of persons the Advisers Act was specifically designed to protect.

To argue that the general partners were not "investment advisers" is to argue that the Advisers Act should not be construed "flexibly to effectuate its remedial purposes," but instead should be construed "technically and restrictively." Indeed, to argue that the general partners were not investment advisers is, in the face of the definition into which they so plainly fit, to argue that the Advisers Act should be construed irrationally.

POINT II

THE FACT THAT FBA WAS A RELATIVELY SMALL, "INTERNALLY MANAGED," INVESTMENT PARTNERSHIP DOES NOT ALTER THE CONCLUSION THAT ITS GENERAL PARTNERS WERE INVESTMENT ADVISERS; NOR DOES THE LANGUAGE IN THE INVESTMENT COMPANY ACT ALTER THIS CONCLUSION

The defendants and *amici* argue that the general partners of investment partnerships in general, and of FBA in particular, are not, because of their characteristics, intended to be regulated as "investment advisers" under the Advisers Act. They first advance the *in terrorem* argument that if the general partners of investment partnerships are deemed investment advisers, then "everyone who manages the investments of others" will also be covered. See Defendants' Petition, pp. 4, 6n.

It is next argued that even if there is no implied exception for investment partnerships in general, nevertheless the situation of FBA involves special and peculiar facts which should lead to the conclusion that the FBA general partners, at least, were not investment advisers. In this connection, the defendants urge that FBA was composed, at least initially (though not in its later stages), almost entirely of the general partners and their families and "friends." It is

also urged that there is some significance to the fact that the general partners invested some of their own money in FBA.

Finally, it is urged in the Steinhardt Brief that the definition of "investment adviser" in the Investment Company Act, even though it is concededly not applicable to the facts of this case, nevertheless shows that "internal managers" of investment vehicles were not intended to be covered by the definition of "investment advisers" in the Advisers Act.

These arguments are untenable. We discuss and refute each of them below.

A. A Ruling That The General Partners Of Investment Partnerships Are "Investment Advisers" Clearly Will Not Mean That Every Person Or Entity Which Manages Funds Of Others Will Similarly Be Covered.

Defendants purport to fear runaway extrapolation of the principles we urge here, in the event it is held that the general partners of investment partnerships are investment advisers. Specifically, Defendants' Petition argues (p. 4),

> "Congress did not intend to subject every trustee of an estate, every officer of a publicly-held company, every controlling partner of a partnership or general part-

> ner of a limited partnership to the Act merely because their activities encompass the management of investments for the beneficial interest of others or because they report thereon to the beneficiaries, stockholders, or partners as the case may be."*

We agree that the Congress' intentions were not so broad as to cast all persons who may conceivably have some responsibility for the investment of funds of others within the ambit of "investment adviser." But holding that the FBA general partners were investment advisers certainly will not open the Pandora's box of applications presaged by defendants and <u>amici</u>.

1. <u>Trustees, including banks and attorneys</u>

It need not be concluded, for example, that "every trustee of an estate" must be held an adviser if the FBA general partners are so held. Many such trustees are banking institutions or lawyers. Such persons are specifically exempt from adviser status under the express provisions of Sections 202(a)(11)(A) and (B). Many other persons who are relatives or trusted friends of a deceased person, for example, and are serving as testamentary trustees, obviously cannot be said to be "in the business" of doing so, and hence are also de-

* A similar argument is made at page 4 of the Steinhardt Brief.

finitionally excluded from adviser status by the express statutory language.

Still other trustees whose investment advising role is merely incidental to more significant functions may, if in doubt about their status, obtain relief from the SEC under Section 202(a)(11)(F), pursuant to which the SEC may by rule, regulation, or order add to the list of persons expressly exempted by the Congress "... other persons not within the intent of this paragraph."*

An example of such action is found in Augustus P. Loring, Jr., 11 S.E.C. 885, 1941-44 CCH Fed. Sec. L. Rep. Transfer Binder ¶ 75,299 (1942), which is cited in Defendants' Petition as supportive of defendants' argument that the Congress did not regard general partners of "internally managed partnerships" as investment advisers. (See Defendants' Petition, p. 7.) The facts of that case, however, in no manner resemble those of the case at bar.

In Loring, a "professional trustee" applied for, and was granted, an SEC order determining that the applicant's activities were "not within the intent" of Section

* The SEC has recently exercised this power, exempting certain employee benefit plan trustees. See 17 C.F.R. § 275.202-1 (1976). It has also, on several occasions, ordered exemptions of specific persons in specific cases.

202(a)(11) of the Act. The SEC noted that the bulk of Loring's business consisted of acting as a "court fiduciary, i.e., trustee, guardian, conservator, or executor under wills or other instruments filed with and under the supervision of the courts" (emphasis added). The SEC further noted that 68% of Loring's income was attributable to administration of trusts and estates under court appointments or irrevocable indentures; that the services he performed went well beyond supervision of investments, including "all other services ordinarily incident to the ownership and management of property;" and that he managed real as well as personal property. Among other observations made by the SEC was the fact that lawyers (who are exempt under the Advisers Act) specialize in very much the kind of work done by Loring. And it noted that he did not solicit business "either as a court fiduciary or under powers of attorney" and

> "...does not hold himself out as being engaged in the business of giving advice to others as to securities. Any advice given by applicant to others as to securities is solely incidental to his activity as a professional trustee."

The SEC, while granting an order of exemption to Trustee Loring, felt compelled to caution that

> "Such order will not relieve applicant from the operation of the Act if, at any time, the facts recited above are materially changed."

We do not believe the factors which moved the SEC to order an exclusion in Loring have any parallel in the FBA partnership, whose sole (not "incidental") attraction to investors was the presumed ability of its general partners to trade securities in a sophisticated and profitable manner.

Defendants also cite Selzer v. Bank of Bermuda Ltd., 385 F. Supp. 415 (S.D.N.Y. 1974). The case is also cited and discussed, with Loring, in the Steinhardt Brief (p. 9). In Selzer, the plaintiff made the defendant bank his trustee for the purpose of commencing "trade in American securities." 385 F. Supp. at 417. The plaintiff subsequently sued the bank for alleged wrongs on a number of grounds, including alleged violations of the Advisers Act. The Court, while noting that "there may be public policy reasons for holding a trustee who deals in securities for its trust to the standards of the Investment Advisers Act," held that the word "adviser" could not be sensibly applied to a trustee. The Court's reasoning was based on "the common sense meaning of the word 'adviser'" and on the idea that a trustee "is historically the legal owner of the trust corpus," and is contained in the following brief statement (p. 420):

> "The trustee does not advise the trust corpus, which then takes action pursuant to his advice; rather the trustee acts himself as principal .... The Court therefore finds that the Investment Advisers Act is not available in a suit against a trustee in these circumstances."

The Advisers Act claim was only one of several claims urged by the plaintiff in Selzer. His claim under Rule 10b-5 withstood the motion to dismiss. The Court was not, for all that the opinion reveals, made aware of any of the legislative history discussed above (pp. 7-9), disclosing that it was indeed the Congress' intent to include within the "advisers" concept those who render advice by managing investors' accounts directly and exercising a discretionary power with respect thereto.

Moreover, because it turns on the historic concept of a trustee's "legal title" to the "trust corpus," the Selzer decision seems entirely too dependent on mere formalism. The Selzer decision was not subjected to appellate review and has not, on the Advisers Act point, been followed by any other court. We believe its precedential value, therefore, to be highly limited.

The Steinhardt Brief (p. 9) notes that "The Commission has held that...a trustee is not an investment adviser,

within the meaning of the Advisers Act," citing Loring, supra, which, as we have discussed above, involved a conventional trustee engaging primarily in judicially supervised activities who did not purport to be an expert in trading securities. The Steinhardt Brief fails to note, however, that the Commission has more recently held that a trustee is an investment adviser where the purpose of the trust is to invest the trust proceeds in securities. Brewer-Burner & Associates, Inc., 1973-74 CCH Fed. Sec. L. Rep. Transfer Binder ¶ 79,719 (1974). [Even the Selzer decision, cited and discussed in the Steinhardt Brief, takes note of the Brewer-Burner holding and concludes that the SEC decisions are in conflict. 385 F. Supp. at 420.]

In Brewer-Burner, the inquiring company proposed to act as a "trustee" under the laws of Panama and intended to solicit American investors to establish with it inter vivos trusts which would invest in securities. The SEC advised (p. 83,925),

> "In our opinion, the Panamanian trust company which is to act as trustee would be an investment adviser within the meaning of Section 202(a)(11) of the Advisers Act .... Accordingly, registration under the Act would be required."

Interestingly, the SEC also cautioned that the trust company may be subject as well to registration under the Investment Company Act, stating (pp. 83,925-26),

> "Furthermore, we disagree with your conclusion that the trustee would not be an investment company within the meaning of the Investment Company Act .... In light of the broad discretion to be vested in the trustee, an investment company may be created if substantially the same or substantially overlapping advice is rendered to each trust or each discernible group or groups of trusts, and where such trusts engage in the same, or substantially the same securities transactions."

Brewer-Burner thus is flatly inconsistent with (a) the argument in the Steinhardt Brief that entities falling within the conceptual scope of the Investment Company Act cannot be subject to Advisers Act regulation; (b) the Steinhardt contention that persons managing invested assets as "principals" cannot be advisers (Steinhardt Brief, p. 9); and (c) the argument in the Defendants' Petition that "internally managed" investment vehicles have not been subject to Advisers Act regulation. Brewer-Burner is not cited in any of these briefs.

2. Corporate officers, and general partners in business partnerships

We think the defendants' suggestion that every of-

ficer of a publicly-held company and every general partner of a partnership would be subject to Advisers Act liability under the rule urged here borders on the frivolous and can be disposed of summarily. The Act is designed to regulate any entity which "engages in the business of advising others" concerning securities. Section 202(a)(11). Companies whose businesses primarily embrace manufacturing, sales, services and the like obviously do not fall within the definition, and investors do not place funds with such organizations chiefly to get the benefit of sage investment counsel. Any incidental investment done by such companies with cash on hand is clearly not within the thrust of the Act. Of course, any company whose principal attraction to investors is the management of investments in securities is within the statutory concern of the Advisers Act and/or the Investment Company Act, and is bound to consider its obligations under either or both.

B. There Is No Reason To Suppose That The Congress Intended To Exempt General Partners Of Investment Partnerships From Treatment As "Advisers" Under The Advisers Act;" Nor Are There Any Special Facts About FBA Which Should Lead To The Conclusion That Its General Partners Are Different From The General Partners Of Other Investment Partnerships.

In support of the proposition that "private investment partnerships" were not intended by the Congress to be subjected to the Advisers Act, Defendants' Petition refers only to the fact that a bill dealing with the Advisers Act was recently introduced in the House of Representatives, but not acted upon. Defendants say that the bill would have directed the SEC to make a study of "who should be included in the term 'investment adviser' ..." (p. 4). Defendants have not described the language of the bill accurately. A copy of the bill is attached as Appendix A to Defendants' Petition. The section referred to actually would have directed the SEC

> "... to make a study of the extent to which persons not included in the definition of 'investment adviser' or spefically excluded therefrom engage in activities which are the same as or similar to those engaged in by investment advisers including but not limited to ... (3) the exercise of investment discretion with respect to securities accounts, and whether the omission or exclusion of such persons from the definition of 'investment adviser' is consistent with the protection of investors and the other purposes of this title ...."

Defendants' Petition argues (p. 4)

> "If the term 'investment adviser' was intended, as the majority has held, to encompass all who manage investments, it would have not been necessary for

> Congress to consider the question as to who should be included in the definition."

It seems clear to us that defendants have completely misread the language of the bill they refer to. Obviously, the question being considered by the Congress was not the question whether persons presently covered by the Advisers Act ought to be excluded; rather, the question was whether certain entities which are now excluded from coverage, such as banks and accountants [see Sections 202(a)(11)(A) and (B)], should be brought within the coverage of the Act for the "protection of investors."

If defendants were correct that the general partners of investment partnerships were not intended to be covered by the Advisers Act, an enormous gap in regulation would result.

The SEC Institutional Investor Study Report, published in 1971, includes certain statistics concerning "unregistered private investment partnerships (Vol. 2, p. 283). Apparently, its conclusions were based on a study of 140 private investment partnerships, but there may have been many more in existence at the time of the study. As the SEC pointed out, "[I]nformation was not available to identify such investment partnerships" (Vol. 2, p. 283, n. 106).

The SEC discovered that as of December 31, 1968, the average size of an investment partnership was $9,000,000 (Vol. 2, p. 284). It also discovered that on that date the aggregate assets of the 140 investment partnerships surveyed were $1.3 billion (Vol. 2, p. 303).

Defendants concede, and would probably insist, that an investment partnership with not more than 100 limited partners (and which is not making or planning a public offering of its securities) is not an investment company, and thus is not subject to any regulation under the Investment Company Act. See 15 U.S.C. § 80a-3(c)(1). At all times, of course, FBA had fewer than 100 limited partners. Defendants would certainly resist vigorously the idea that FBA was ever an "investment company" within the meaning of the Company Act.

Yet defendants also insist that the general partners are not, and were not intended to be, covered by the Advisers Act either. There is nothing in the language of the Advisers Act to support this argument, and its acceptance would thwart the Congressional intent to impose federal control upon investment advisers involved in "widespread activities" and wielding a serious "potential influence on security markets." S. Rep. No. 1775, 76th Cong., 3d Sess., 21 (1940). The statistics compiled by the SEC

in the Institutional Investor Study make it quite apparent that the general partners of investment partnerships, because of their number and the size of the funds they control, engage in "widespread activities" and certainly exert significant "influence on security markets."

Although defendants try to argue that the general partners have fortunately fallen into a regulatory gap, it is virtually certain that the Congress did not intend to leave the gap defendants are now trying to create. As this Court has already pointed out (slip opinion, p. 6225), the Report of the Senate Committee on Banking and Currency reveals, almost in so many words, that the intent of the Congress was to close gaps, not create them. The Senate Report above quoted observed,

> "Virtually no limitations or restrictions exist with respect to the honesty and integrity of persons who may solicit funds to be controlled, managed, and supervised." S. Rep. No. 1775, 76th Cong., 3d Sess., 21 (1940).

Plainly, if defendants are correct that general partners of investment partnerships having fewer than 100 limited partners are not subject to the Advisers Act, then there will remain "[v]irtually no limitations or restrictions" with respect to a great many "persons who may solicit funds to be controlled, managed, and supervised."

* * *

There are no special facts concerning FBA which lead to the conclusion that its general partners were different from other general partners of investment partnerships.

Defendants' Petition argues that the Court "misapprehended the nature of FBA" (p. 5), and asserts that FBA was comprised of the general partners, their families, their relatives, and their "friends" (p. 5). Defendants argue, on this basis, that FBA was a "private" entity and that the general partners did not solicit the funds of the "public" (p. 6). Defendants finally urge that the general partners themselves made a substantial investment in FBA, that they assumed its liabilities, and that these facts are somehow significant and make FBA different from other investment partnerships.

In fact, FBA is a typical example of the investment partnerships surveyed by the SEC in the course of its Institutional Investor Study. As the SEC said (Vol. 2, p. 290),

> "The typical hedge fund is organized as a limited partnership with one or more general partners who manage the funds and a much larger number of limited partners who do not participate in investment decisions."

The SEC discovered, moreover, that of the 127 limited investment partnerships surveyed, 54 had fewer than 15 limited partners; 35 had between 15 and 29 limited partners; 21 had between 30 and 49 limited partners; 13 had between 50 and 74 limited partners; and 4 had between 75 and 99 limited partners. (Vol. 2, p. 306). FBA, it will be recalled, had 35 limited partners by April 1, 1966, and had 66 limited partners by October 1, 1968 (slip opinion, p. 6215). The stress placed by defendants on the allegedly "private" and intimate nature of FBA would seem to be ill-advised; in 1968, FBA was larger than at least 87% of the limited investment partnerships surveyed during the SEC's Institutional Investor Study.

Defendants point to no decisional law, statutory language, or legislative history to support the proposition that the general partners of a "typical" limited investment partnership are not investment advisers, because the enterprise is "private" and because the funds of the families, relatives and "friends" of the general partners are invested.

In fact, defendants admit that persons other than the general partners and their families owned nearly half of the total capital of FBA on October 1, 1966 and on October 1, 1967; they admit that persons other than the general

partners and their families owned over 60% of the capital of FBA on October 1, 1968 (Defendants' Petition, p. 7).

In any event, we know of no authority for the proposition that remote relatives and "friends" are not members of the "public."*

It would be difficult to imagine any decision remotely supporting the view that general partners may operate a fund governed by a 22-page agreement (87a) with as many as sixty-six investors and $60 million in pooled assets, receive compensation of $25,000 in salary plus 20% of yearly net profits and net capital gains (slip opinion, p. 6215), and yet urge that laws ordinarily regulating such financial relationships are inapplicable because most of the investors were relatives and friends and the "public" was unaffected.

* We agree that protection of the investing "public" was a primary purpose of the Advisers Act, but it was not the only purpose. It seems to us, for example, that the Congress intended to include even a person who does not "hold himself out generally to the public as an investment adviser" within the term "investment adviser," if his activities otherwise fit the definition. See Section 203(b)(3), which eliminates the registration requirement for an adviser who has "fewer than fifteen clients and who neither holds himself out generally to the public as an investment adviser nor [advises a registered investment company]" but does <u>not</u> exempt such persons from the definition of "investment adviser."

Defendants make their argument about the "privacy" and intimacy of FBA (and the consequent inappropriateness of Congressional regulation) without once adverting to the very provision of the Advisers Act that is designed to accommodate such considerations. Section 203, which prescribes registration of investment advisers, further provides:

> "(b) The provisions of subsection (a) of this section [mandatory registration] shall not apply to
>
> * * *
>
> "(3) any investment adviser who during the course of the preceding twelve months has had fewer than fifteen clients and who neither holds himself out generally to the public as an investment adviser nor acts as an investment adviser to any investment company registered under subchapter I of this chapter."

By this paragraph, the Congress eased, to the extent it saw fit, the regulatory burdens on adviser activities such as those allegedly engaged in by the general partners here, activities which affect only a small number of people and do not involve solicitations of the public.* The exemption is not from the definition of

* Whether FBA or its general partners were obligated to register as advisers is a separate question, which need not be determined in this case, in light of the applicability of the antifraud provisions of Section 206 to all advisers, irrespective of registration obligations.

investment adviser or the antifraud rules of Section 206, but only from the requirement to register.

The Congress, in Section 203, clearly considered the very question now being raised by the defendants and amici: whether a small number of clients, a "private" enterprise, and a lack of public solicitation should be sufficient to exempt an investment manager from the definition of "investment adviser." While defendants urge that the Congress did not intend to regulate such persons under the Advisers Act, Section 203 makes it quite clear that the Congress felt only that such persons need not register.

Finally, defendants point out that the general partners here invested their own money in FBA. This, like the other factors relied on by defendants, still does not take FBA out of the category of "typical" limited investment partnership. As the SEC Institutional Investor Study revealed, it is quite ordinary for general partners to make substantial capital contributions to their investment partnerships (Vol. 2, p. 291).*

* In any event, it can hardly be supposed that the Congress viewed the limited partnership form differently from other advisory relationships. The general rule is that while limited partners must contribute capital to a limited partnership, general partners need not. 68 C.J.S. "Partnership," § 456. Thus, the Congress plainly could not have reasoned that investment advisory services structured as limited partnerships have "risk-sharing" aspects which obviate the need for regulation under the Advisers Act.

Moreover, it is utterly unrealistic to suggest, as defendants do, that the policies of the Advisers Act are served, and the investors amply protected, by the fact that the general partners placed their personal funds in the investment pool.* At best, this fact gives moderate assurance that the general partners will try to invest in profitable investments. The contributions to the pool by the general partners could not alleviate the true problems with which the Advisers Act is concerned--the possibility, for example, that a general partner may steer partnership funds toward securities of companies in which he had individual investments or loans (or other financial interests); the possibility that the general partners, having lost, squandered, or appropriated partnership funds, might endeavor to conceal that fact from the investors; or the possibility (an actuality in this case) that the general partners followed investment strategies at odds with those they claimed to abide by in representations to investors.

* It happens not infrequently that the perpetrator of a securities fraud will himself suffer loss by reason of having committed his own funds to the fraudulent venture. Whether the defendant profited or lost money is immaterial. United States v. Corr, U.S.D.C., S.D.N.Y., 75 Cr. 803, 1059 (Tr. 4392; Weinfeld, J.), aff'd, 543 F. 2d 1042 (2d Cir. 1976).

It is little comfort to one who loses money entrusted to another, who gambled while promising caution and safety, to know that the gambler took the same foolish chances with his own funds. In the present case, for example, the general partners may well have been willing to play their undisclosed high-stakes game, not only because of the possibility that their own invested capital might appreciate, but also because of the possibility that they might reap substantial harvests in the form of their 20% share of all net profits and capital gains on partnership capital.

Plainly, this sort of misconduct is always possible, even where the general partners have invested considerable sums. The fact of their investment lends no support at all to the proposition that they were not investment advisers.*

* * *

* Defendants' two remaining arguments need not be dealt with at length. Defendants point out that they assumed the risk of FBA's liabilities. But it is not explained how this assured that they would deal fairly and honestly with the limited partners, as opposed to the creditors of the partnership. It is noteworthy that the general partners did not, as they seem to suggest, actually put themselves in the same boat as the limited partners. In the 1968 revised partnership agreement, the general partners inserted the special privilege, available to managing partners only, of withdrawing substantial amounts of capital at any time during the year. See § 4.02 (98a). Limited Partners could make withdrawals only at the end of a fiscal year. See § 4.03 (98a).

[Footnote continued on p. 40]

To summarize, there is nothing in the nature of investment partnerships in general, or FBA in particular, to suggest that their general partners are not investment advisers.

We are evidently not the first to reach this conclusion. It is fascinating to note that the FBA general partners themselves must have realized at an early stage that they were acting as investment advisers. In the partnership agreement dated July 1, 1965, and also in the partnership agreement dated April 1, 1966, there is listed, among the powers and duties of the general partners, the power

> "... to engage in the business of advising and counselling on investments and to enter into agreements therefor; ..."

[Footnote continued from p. 39]

Defendants also argue that the general partners were subject to state fiduciary law remedies. The Advisers Act was specifically designed to recognize "'the delicate fiduciary nature of an investment advisory relationship.'" SEC v. Capital Gains Research Bureau, 375 U.S. 180, 191 (1963). The Congress intended, however, to make the enforcement of those fiduciary obligations a matter of federal concern. The legislative history so indicates (see our initial supplemental brief, pp. 13-16), and this Court seems to have agreed (slip opinion, pp. 6230-31). The Advisers Act, moreover, goes farther than state law, in proscribing certain kinds of compensation arrangements, for example; in prohibiting contracts purporting to waive compliance with the Act (the general partners attempted to impose just such a contract in this case, see § 2.04 of the 1968 partnership agreement, which purports to authorize certain conflicts of interest); and in providing criminal penalties.

See partnership agreement dated July 1, 1965, Article Third, p. 4 (42a); partnership agreement dated April 1, 1966, Article Third, p. 5 (70a).*

C. The Definition of "Investment Adviser Of An Investment Company" Under The Investment Company Act Lends No Support To The Proposition That The FBA General Partners Were Not Investment Advisers For Purposes Of The Advisers Act; In Fact, It Supports The Conclusion That They Were Advisers.

It is urged in the Steinhardt Brief (p. 5) that the definition of "investment adviser" to investment companies found in section 2(a)(20) of the Investment Company Act discloses a Congressional intention to exclude from any regulation as investment advisers the "internal investment managers" of investment vehicles. Section 2(a)(20), 15 U.S.C. § 80a-2 (a)(20), provides, in pertinent part:

> "'Investment adviser' of an investment company means (A) any person (other than a bona fide officer, director, trustee, member of an advisory board, or employee of such company, as such) who pursuant to contract with such company regularly furnishes advice to such company with respect to the desirability of investing in, purchasing or selling securities or other property, or is empowered to determine what securities or other property shall be purchased or sold by such company ...."

* References to the "business of advising and counselling on investments" do not appear in the 1968 revision of the partnership agreement, parts of which appear to have been drafted in the realization that there were potential Advisers Act implications in the relationship. There is no indication, however, that the actual functions of the general partners changed in any way following the execution of the 1968 revision.

We are told, in the Steinhardt Brief, that the above-quoted definition was drawn to exclude internal managers (i.e., any "bona fide officer, director," etc.) from the regulation of investment advisers under the Investment Company Act and that it would be "illogical and inequitable" to find that general partners of investment vehicles exempted from the Investment Company Act "are nonetheless 'investment advisers' although they perform the same management function as their non-adviser counterparts at registered companies." (Steinhardt Brief, pp. 8-9).

The suggestion implicit in this argument is that "internal investment managers" of registered investment companies are not regulated under the Investment Company Act, and that therefore it would be "inequitable" to hold that "internal investment managers" of investment partnerships, such as the general partners, should be regulated under the Advisers Act.

The fact is, however, that the internal managers of registered investment companies are subject to strict regulation under the Investment Company Act. Only if it were held that the general partners of investment partnerships such as FBA are <u>not</u> covered by the Advisers Act would an anomaly arise, for such general partners would then be totally unregulated while their "counterparts" in registered companies would be subject to regulation.

While officers, directors and other "internal" managers of a registered investment company are, indeed, excluded from the definition of "investment adviser" in the Company Act, they are nevertheless made subject to stringent liabilities under section 36(a) of the Investment Company Act.* The SEC is authorized thereunder to bring civil actions for injunctive and other relief alleging

> " ... that a person serving or acting in one or more of the following capacities has engaged within five years of the commencement of the action or is about to engage in any act or practice constituting a breach of fiduciary duty involving personal misconduct in respect of any registered investment company for which such person so serves or acts --
>
> (1) as officer, director, member of any advisory board, investment adviser,** or depositor."

Section 36(a) of the Investment Company Act thus imposes liability for misconduct of "internal managers" of investment companies quite similar in nature to the prohibitions of Section 206 of the Advisers Act, the section on which lia-

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* 15 U.S.C. § 80a-35.

** It is interesting that the Congress has provided, in subsection "(c)," that for purposes of subsections "(a)" and "(b)," "'investment adviser' includes a corporate or other trustee performing the functions of an investment adviser." 15 U.S.C. § 80a-35(c); see also 15 U.S.C. § 80a-9(d).

bility in the present action is premised.* Investors have been held to have an implied right of action under section 36. Moses v. Burgin, 445 F. 2d 369, 373 (1st Cir. 1971), cert. den., 404 U.S. 994 (1971).

Section 36 of the Company Act thus makes it clear that the Congress had no thought of making "internal managers" of investment companies exempt from all regulation or liability.** The reason they are excluded from the definition of

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* In our initial supplemental brief, at pp. 13-16, we pointed out that the Congress in the Advisers Act enacted provisions that would recognize the fiduciary nature of the adviser-client relationship. Thus, the Supreme Court stated in SEC v. Capital Gains Research Bureau, 375 U.S. 180, 191 (1963), "The Investment Advisers Act of 1940 reflects a congressional recognition of the delicate fiduciary nature of an investment advisory relationship...."

** The Steinhardt Brief also seems to suggest obliquely that if the general partners of an investment partnership are held to be "investment advisers," then all "internal investment managers"--including the internal managers of registered investment companies--would also be deemed advisers for purposes of the Advisers Act. This suggestion does not seem to us to be so dreadful as the Steinhardt Brief pretends, and the result would not, in practice, create severe problems. As we have urged throughout, the internal managers of an unregistered investment vehicle should certainly be governed by the Advisers Act, else they would be subject to no regulation at all. The internal managers of registered companies on the other hand, since they are subject to extensive regulation as described in this brief, might well have a strong argument that they should not be covered by the Advisers Act. It is open to them to apply for an exemption under Section 202(a)(11)(F). It might also be proper for a court to hold that they are not advisers, under the authority of the opening sentence of Section 202(a), which provides that the definitions in that section are to be used "un-

[Footnote continued on p. 45]

"investment adviser" in the Investment Company Act may be inferred from section 15(c) of that Act. It is there provided that the contracts of advisers to investment companies must be in writing, must be approved by a majority vote of the shareholders, and must contain written mandatory provisions including disclosure of compensation and terms limiting the duration of service. Apparently, the Congress felt that it would be unnecessary and perhaps unwise to provide for similar regulation of "internal investment managers." This decision seems sensible. If an investment company were required to obtain a stockholder vote before it could hire an officer or portfolio manager, for example, the operations of such company could be practically paralyzed.

It is also pertinent that the investor in a registered investment company enjoys other substantial statutory protection against less than aboveboard conduct by the managers of an investment company. For example, a registered company is required to disclose its investment policies in

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[Footnote continued from p. 44]

less the context otherwise requires ...." It appears that the SEC itself, though it regards internal managers of unregistered companies to be advisers, nevertheless has taken no action against internal managers of registered companies who have not registered under the Advisers Act. See Steinhardt Brief, p. 6, note 8 and accompanying text. Regardless of whether registration is required of them, however, the "officers" of certain "internally managed closed-end registered investment companies" are clearly viewed as advisers by the SEC. See Institutional Investor Study Report, Vol. 2, p. 140. We suggest that the question of how managers of registered companies are to be treated need not be resolved in this case.

its registration statement pursuant to section 8. In Green v. Brown, 276 F. Supp. 753 (S.D.N.Y. 1967), a case involving alleged deviation from the statement of policy required by section 8, the Court said (p. 756),

> "The purpose of the registraton statement is to provide information as to the company's proposed activities 'for the protection of investors'."

The disclosure mandated in section 8 of the Investment Company Act would, in the instant case, have compelled a clear statement as to FBA's investment policy regarding unregistered securities, if FBA had been subject to the Investment Company Act.

In Investment Company Act Release No. 7220 (June 9, 1972), 2 CCH Fed. Sec. L. Rep. ¶ 7178, the SEC set forth guidelines for the preparation of registration statements to be filed by the investment companies registered under the Investment Company Act. The guidelines state that the investment policies of the company "should be clearly and concisely stated so that they may be readily understood by the investor" (p. 13). In particular, in the section headed "Types of Securities" (p. 14), it is stated that when the company intends to invest in restricted securities, the following disclosure should be made (p. 15):

> "The company will invest in securities which may not be sold publicly until first registered under the Securities Act of 1933."

In another section, dealing with securities having a limited trading market, it is recommended that the disclosure be made that the company's holdings of such securities may be such as to "affect adversely the liquidity or marketability of such securities ..." (p. 17).

The guidelines, finally, state that a very detailed disclosure is required concerning restricted securities which are held in the portfolio. On this subject the guidelines state, in part (p. 21),

> "The usual limit on aggregate holdings by an open-end company of illiquid assets of all kinds including restricted securities, is 10% of the value of its net assets. <u>If a Company has a policy of investing in restricted securities which amounts to 2% of the value of its net assets, this should be clearly stated</u>. When as a result of either the increase in the value of some or all of the restricted securities held or the diminution in the value of unrestricted securities in the portfolio, the restricted securities come to represent a larger percentage of the value of the Company's assets <u>serious liquidity questions may arise</u>. Accordingly, if the fair value of restricted securities increases beyond 10%, it would be desirable for the open-end company to consider appropriate steps to protect

> maximum flexibility. The statement should include a discussion in general terms of what a restricted security is, the limitations upon the sale of such securities, the procedure established for valuing such securities, and a discussion of the special risks involved in a program of purchasing securities which may not be publicly sold without registration. In any event, as to any restricted security held in the portfolio, the following information should be set forth in a note to the Schedule of Investments portion of the financial statements:
>
> 1. Identification of any restricted Securities, and their date of acquisition." (Emphasis added.)

Moreover, the SEC in Accounting Series Release No. 113, Investment Company Act Release No. 5847 (October 21, 1969), 5 CCH Fed. Sec. L. Rep. at ¶ 72,135, in a comprehensive discussion entitled "Problems of Investment Company Ownership of Restricted Securities," warned that

> "The Commission, however, is of the view that a prudent limit on any open-end company's acquisition of restricted securities, or other assets not having readily available market quotations, would be 10 per cent."

And the SEC therein made it clear that a company's policy regarding investments in unregistered securities is "fundamental" and not alterable except through shareholder vote pursuant to section 13 of the Investment Company Act.

Obviously, the general partners of FBA, had they been subject to regulation under the Investment Company Act, would have been guilty of serious and substantial violations under that regulatory scheme in causing FBA's investment in restricted stock to swell to 72%-88% of the portfolio (slip opinion, p. 6217) without any disclosure of such a policy to the investors.

The investors in FBA, however, did not enjoy the benefits of the above-cited disclosure requirements, restrictions against investment policy deviation and breach of fiduciary duty provisions because the Investment Company Act was not applicable to FBA.

The Steinhardt Brief argues (p. 5) that all investment vehicles, and their related personnel, were meant to be regulated, if at all, only under the Investment Company Act. FBA, however, was not subject to regulation under the Investment Company Act, for the simple reason that it was not an investment company. Section 3(c)(1) specifically excludes from the <u>definition</u> of "investment company" any issuer "whose outstanding securities ... are beneficially owned by not more than one hundred persons and which is not making and does not presently propose to make a public offering of its securities." The logical extension, then, of the argument in the Steinhardt Brief is that conduct which would be absolutely

prohibited to the "internal managers" of a registered company by section 8 of the Company Act, and which would subject them to liability under section 36 of that Act, is conduct which may be engaged in with impunity by general partners of unregistered investment partnerships.

In short, it is contended that such entities as FBA are within the statutory concept of the Company Act, that they may enjoy its exemptions, but they are beyond the reach of its taboos. In our view, this result, to borrow a phrase used in the Steinhardt Brief itself, would indeed be "illogical and inequitable."

In the light of the foregoing, it seems clear that the exclusion of "internal managers" from the definition of "investment adviser" in the Investment Company Act does not signify in the slightest a Congressional intention to exclude the same persons from the coverage of the Advisers Act. Indeed, as we have urged above, the fact that the Congress thought it necessary to provide an <u>express</u> exemption for such persons in the Company Act definition suggests quite strongly that without such express exemption "internal investment managers" would certainly have been included within the definition of "investment adviser."

Moreover, the evidence is quite clear that the

difference in the wording of the definitions of "investment advisers" in the Advisers Act on the one hand, and in the Company Act on the other, was not inadvertent. The evidence is quite clear that the Congress was fully conscious of the fact that it had excluded certain internal managers from the definition of "investment adviser" in the Company Act, but had not excluded them from the definition in the Advisers Act. This is demonstrated by the provisions of section 9 of the Company Act, 15 U.S.C. § 80a-9. That section contains provisions making it unlawful for certain persons "to serve or act in the capacity of employee, officer, director, member of an advisory board, investment adviser, or depositor of any registered investment company ...." The persons made ineligible to hold such offices include persons convicted of certain securities-related crimes in the previous 10 years, and persons who are enjoined by reason of securities-related misconduct. The term "investment adviser," as used in section 9, is not limited by the definition set forth in section 2(a)(20) of the Investment Company Act, however. The last sentence in subsection "(a)" of Section 9 states,

> "For the purposes of paragraphs (1)-(3) of this subsection, the term 'investment adviser' shall include an investment adviser as defined in subchapter II of this chapter." (Emphasis added.)

By this sentence, the Congress quite deliberately adopted, for purposes of section 9, the definition of "investment adviser" which is found in the Advisers Act.

This seems to us to constitute unmistakable evidence that the Congress understood full well the difference between the two definitions, and deliberately made the prohibitions of section 9 of the Company Act applicable to investment advisers whose contracts might not be in writing and who are "internal investment managers."

That being so, we do not think it can be validly argued that "internally managed" investment vehicles are not subject to regulation under the Advisers Act.

POINT III

PRIOR RULINGS BY THE SEC INDICATE THAT THE ADVISERS ACT WAS INTENDED TO COVER THE GENERAL PARTNERS OF INVESTMENT PARTNERSHIPS, AND NOT THAT SUCH PERSONS WERE INTENDED TO BE EXCLUDED FROM REGULATION

Defendants' Petition asserts that the SEC has "never attempted to regulate private investment partnerships" under the Advisers Act (p. 7). It also asserts that several SEC rulings issued in the 1940's "establish" that it was not the intention of the Congress to regulate "internally managed" investment partnerships (p. 7). See also Steinhardt Brief, p. 9.

Both assertions are incorrect.

Defendants rely on three rulings in which the SEC, pursuant to its statutory authority under Section 202(a)(11)(F) of the Advisers Act, exempted particular persons from "investment adviser" status. In the Matter of Roosevelt & Son, Investment Advisers Act Release No. 54, 1948-52 CCH Fed. Sec. L. Rep. Transfer Binder ¶ 76,016 (1949); In the Matter of Augustus P. Loring, Jr., 11 S.E.C. 885, 1941-44 CCH Fed. Sec. L. Rep. Transfer Binder ¶ 75,299 (1942); and In the Matter of The Pitcairn Company, Investment Advisers Act Release No. 52, 1948-52 CCH Fed. Sec. L. Rep. Transfer Binder ¶ 75,990 (1949).

The _Loring_ decision is discussed above in Point II. We there point out that Loring was exempted because his trusteeships were conducted primarily under court supervision, because they involved a variety of management duties including the administration of real property, and because any investment advice he gave concerning securities was only "incidental" to his other functions. It should also be noted that _Loring_ involved no multi-member "investment vehicle" which could be said to have been "internally managed."

The _Roosevelt_ ruling similarly did not involve an "internally managed investment vehicle." The Roosevelt brothers were the partners in a partnership which managed certain investments, but the accounts they serviced were owned by persons who were not partners at all. _Roosevelt_ appears to have been another situation in which an exemption was granted because the advice as to securities investments was insubstantial in relation to the entire business. The SEC specifically noted in its ruling that only a relatively small part of the Roosevelt brothers' time was spent on the management of securities portfolios; the bulk of their time was spent in administrative and clerical duties with respect to various property, both real and personal. The SEC also observed that the Roosevelts did not

solicit new accounts and that the number of non-family accounts had been steadily declining. At the time of the ruling, over two-thirds of the accounts being handled belonged to members of the Roosevelt family, and almost all of the remainder belonged to close associates who had "been with the firm for a great many years ...."

The Pitcairn case involved a close corporation which did significant investing. But all of the stock was owned legally or beneficially by Raymond, Theodore and Harold Pitcairn, their spouses, descendants, and descendants' spouses, except for relatively small holdings by two officers of Pitcairn, its counsel and several churches. The company had never solicited anyone to use its services, and affirmatively represented to the SEC that it would not render its service to anyone except officers or stockholders and that it had no intention of "enlarging the group to which it gives investment advice." Finally, the services performed by the firm were rendered "substantially at cost."*

* This fact would seem to cast doubt on whether The Pitcairn Company was "in the business" of giving advice as to securities "for compensation," as those words are used in Section 202(a)(11) of the Advisers Act. The fact that any investment advisory services were rendered on a basis not calculated to be profitable probably had a significant influence on the ruling.

All three of the rulings relied on by defendants are thus seen to have involved unique fact patterns. They should be held to be limited to their facts.

The rulings relied on by defendants should be compared to more recent SEC rulings such as Philip Eiseman, CCH Fed. Sec. L. Rep. ¶ 80,914 (July 22, 1976), in which the SEC staff specifically declined to apply the Loring case, pointing out that it was "based on certain specific facts and circumstances ..." (p. 87,413). In Eiseman, the applicant gave investment advice in connection with several family investment accounts and trusts. He represented that he did not intend to solicit additional clients or hold himself out to the public as an adviser. The SEC staff stated (p. 87,413),

> "By providing investment advice for compensation to various family trusts and investment accounts, either through the performance of investment supervisory services or the issuance of advisory opinions, Mr. Eiseman falls within the definition of the term investment adviser contained in Section 202(a)(11) of the Act and would therefore be required to register as such unless an exemption from registration is available."

See also Brewer-Burner & Associates, Inc., 1973-74 CCH Fed. Sec. L. Rep. Transfer Binder ¶ 79,719 (1974), discussed in Point II above, in which the SEC advised that a Panamanian

trust company proposing to solicit a number of trusts to be settled by American investors for the purpose of investment in securities would be required to register under the Advisers Act and possibly under the Company Act as well.

The SEC staff issued a similar opinion in *Rami Hofshi*, 1973 CCH Fed. Sec. L. Rep. Transfer Binder ¶ 79,441 (1973), which clearly involved an "internally managed" investment vehicle functioning indistinguishably from the investment partnership in the case at bar. There, it appeared that Mr. Hofshi was the "operations partner" of an "investment club." In this capacity he made "all of the investment decisions for the club," and received compensation therefor. The SEC staff advised,

> "An investment adviser is defined as any person who, for compensation, engaged in the business of advising others, either directly or through publications or writings, as to the value of securities or as to the advisability of investing in, purchasing, or selling securities or who, for compensation and as part of a regular business, issues or promulgates analyses or reports concerning securities. *It appears that you would fall into this category and would be required to register as an investment adviser, unless some exemption is available*." (Emphasis added.)

The SEC, finally, has expressed itself very clearly, in the Institutional Investor Study Report, on the status of general partners of investment partnerships. Defendants' Petition chides the SEC (p. 7) for omitting to refer to the Institutional Investor Study Report in its *amicus* brief. Defendants say that the SEC reported, in the Institutional Investor Study Report, on "private investment partnerships without the slightest suggestion that it regarded the general partners of such partnerships as 'investment advisers' ..." (p. 7).

Defendants are simply wrong. They apparently have not read the Institutional Investor Study Report with sufficient care. The Report states (Vol. 2, p. 140),

> "This chapter considers both registered and non-registered investment advisers. Among the non-registered advisers included are advisers whose only clients are mutual funds, the officers of several internally managed closed-end registered investment companies, the general partner(s) of a number of private investment partnerships ('hedge fund') and the advisers to several offshore funds." (Emphasis added.)

Elsewhere in the Institutional Investor Study Report, a similarly unmistakable expression of the SEC's viewpoint appears. The SEC concluded that no new legislation would be required in order to regulate the activities of

general partners of investment partnerships. Plainly, the SEC believed that such persons are covered by the Advisers Act (Vol. 1, pp. xv-xvi):

> "The Study examined the activites of hedge funds. These investment vehicles generally are organized as limited partnerships having fewer than 100 partners....
>
> "Although hedge funds bear attributes of investment companies and their general partners perform many of the same functions as investment advisers, neither the funds nor their general partners ordinarily are registered under either the Investment Company Act or the Investment Advisers Act of 1940 ....
>
> "As a result of the Study's review of hedge funds' operations, it now appears practicable to clarify the applicability to hedge funds of registration requirements under one or more of the Investment Company Act of 1940, the Investment Advisers Act of 1940 and the Securities Exchange Act of 1934, and to formulate any necessary rules regarding such funds under the appropriate laws. The Commission does not believe that new legislation is required and will take the steps necessary to accomplish this purpose." (Emphasis added.)

See, finally, the views expressed by Mr. Ezra Weiss, formerly chief counsel to the SEC's Division of Trading and Markets, in an address to the Practicing Law Institute, reprinted in Investment Partnerships and "Offshore" Investment Funds (PLI, 1969), at pp. 361-371. Mr. Weiss' analysis is

quoted in our initial supplemental brief (pp. 39-40), and need not be repeated here. In short, Mr. Weiss stated his belief that the general partner of a limited investment partnership "is an investment adviser."

On the basis of the foregoing, we respectfully urge that the SEC has at all times regarded the general partners of investment partnerships to be "investment advisers" for purposes of the Advisers Act. The only rulings defendants can point to in which the SEC has held particular persons not to be "investment advisers" have involved unique facts not present here.

CONCLUSION

Defendants would presumably concede that if they managed the investments of 66 other individuals, without making those individuals their limited partners, there would be no question that an adviser-client relationship existed. Defendants say, however, that because they were merely the general partners of a private investment partnership, they were not advisers. They say that the partnership "invested only its own funds" (Petition, p. 5). Similarly, the Steinhardt Brief contends that because the enterprise was in partnership form, the general partners acted as "principals" (p. 9).

We find this argument not entirely clear. The fact is that the general partners of FBA managed the money of the limited partners, and no amount of distortion or references to the partnership's "own funds" can change this fact. We urge that the decision whether a person is is an investment adviser cannot turn on such superficial factors as the form of business organization he has chosen. Rather, we urge, that decision should be made on the basis of an analysis of what the alleged adviser does, of how he functions, and of what reliance is placed upon him.

Here, the general partners advised others as to securities by investing funds on a discretionary basis and sending periodic reports summarizing investment activity. They did so for very substantial compensation, and as part of a regular business.

Defendants fit the definition of "investment adviser" set forth in the Advisers Act, and there is no reason whatever to conclude that they were not intended to be covered. The legislative history shows that the Congress intended the Advisers Act to control the activities of persons who do precisely what the general partners here do. Moreover, if the general partners were held not to be investment advisers, a gaping hole in the regulatory scheme provided for under the Advisers Act and the Investment Company Act would be created.

For the reasons set forth above and in our previous briefs, it is respectfully urged that the general partners of FBA were "investment advisers" within the meaning of the Investment Advisers Act of 1940.

Respectfully submitted,

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Service of three (3) copies of the within is admitted this 6 day of May 1977

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